Special Address

The deposit insurer's role in transitioning from a government deposit guarantee

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It is an honour for me to participate once again in this prestigious symposium and I appreciate the opportunity to be here today to speak to this distinguished group. Many thanks to Ray LaBrosse and the organizers of this symposium for this kind invitation. Having seen and participated in the success of last year's symposium, the Malaysia Deposit Insurance Corporation, or otherwise known as MDIC, is, once again, proud to be a co-sponsor of this symposium.

What a difference a year makes! This time last year, the global economy was mired in the depth of the worst recession since the Great Depression. Fast forward one year, recent months have brought better economic news with traces of more sustaining growth becoming more visible. At the time of writing, the healing of financial conditions along with gradually building public confidence remains supportive to keep the recovery going. As the dust settles, I hope we can now better see the proximate causes of the crisis and solutions to these problems. Hence, it is good for us to reconvene in Warwick at a time of recovery from the financial crisis.

This year's symposium on managing systemic risks, and the topics being discussed, is of great importance to all of us here who share a common interest in fostering the stability of the financial system. Indeed, with global financial risks now receding, this is an opportune time for us to come together to reflect and discuss pertinent issues on managing and preventing systemic risks. In line with the theme of the symposium, my remarks today are on a deposit insurer's role in transitioning from a government deposit guarantee (GDG).

It is indeed fact that the implementation of extraordinary measures, including the introduction of GDG, have helped to prevent the global economy from sinking further into an economic abyss. However, while necessary to avert an economic disaster of this proportion, such support measures can distort financial efficiency and erode market discipline.

More perversely, they encourage moral hazard and substantially distort incentives. In fact, the current crisis has generated what I believe to be the 'mother of all' moral hazard! The general public and 'too-big-to-fail' financial institutions are again being conditioned to believe that the government would always step in with a blanket guarantee or bail them out whenever risks materialize. It also leaves no doubt that such distortions could encourage banks to continue taking excessive risks in the future. This would, eventually, sow the seeds for future crises.

Hence, given their nature, a clear message needs to be sent to explain that such measures are temporary. Measures should also be implemented to mitigate 'too-big-to-fail' expectations and conditions to always step in to help. And, it is prudent economic management if they are unwound as soon as conditions return to normal. Correct timing to unwinding is, therefore, crucial. Pre-conditions for exit would require that economic conditions are stable and improving and that the banking system, underpinned by strong prudential regulation and supervision, is safe and sound. Also, it should be carried out at a time when consumer sentiment is up and depositors have a 'feel good' sense about the general economic conditions, their income and job prospects. Now that we are on a bit of firmer ground, the issue of 'when' and 'how' to pull back the unorthodox measures should definitely heat up. For deposit insurers, I believe the stage is now set, especially for some of us with a 2010 year-end deadline, to start planning, if we haven't, for an exit from these measures. The challenge, therefore, is to formulate and execute a well-planned, highly coordinated and comprehensive exit strategy to a credible alternative that would not destabilize depositors' confidence and the financial system. This serves as the broad objective for any exit strategy. In other words, the transition must be a non-event in the eyes of the public. To achieve this, how can we revert to an explicit deposit insurance scheme while, at the same time, being able to promote and enhance public confidence?

I must concede that this is a tall order. And, there remain wider concerns that the general public has been conditioned to expect the government not to quickly remove benefits given to them. It is difficult but, with the right plan and strategies, not impossible. For deposit insurers, we will be held accountable in our ability to maintain confidence during the transition. This being one of our key functions, it is natural for deposit insurers to spend time and energy planning for the transition process.

I would like to share some thoughts on what we are working on in Malaysia and from my personal perspective as a seasoned deposit insurance practitioner for the last 35 years. I have organized my remarks into four sections. First, I will briefly review the actions taken by deposit insurers to mitigate the crisis, the pre-announced exit timelines and some

preparatory actions taken recently by Australia, New Zealand, Hong Kong and Singapore. Second, I discuss Malaysia's preliminary thoughts about our exit strategy and look into our role in managing the transition. Third, I will highlight some desired principles that should promote a smooth transition. In the last section I provide some conclusions.

I. RECENT CRISIS MITIGATING ACTIONS BY DEPOSIT INSURERS

According to a joint survey by the International Association of Deposit Insurers and the International Monetary Fund released in September 2009 that had the aim to identify strategies to unwind temporary depositor protection, it was found that 46 jurisdictions adopted policies to enhance depositor protection during the crisis of which 28 jurisdictions opted to increase coverage levels ranging from 75 per cent to 400 per cent while 18 jurisdictions provided full or partial depositor guarantees.

Of the 25 jurisdictions that adopted either temporary full depositor guarantees or temporary increases in deposit insurance coverage levels, 18 jurisdictions have announced scheduled expiry dates, with the majority of timings falling between 2010 and 2011. The survey showed that eight jurisdictions, including four in Asia, will exit from guarantees between September to December 2010.

Some countries have recently taken preparatory steps towards such an exit. While still maintaining the guarantee for retail deposits, both Australia and New Zealand have announced the removal of wholesale funding from the government guarantee. In the UK, the 100 per cent deposit protection for customers of Northern Rock will soon be lifted. And, driven by the primary objective of protecting small depositors, both Hong Kong and Singapore have proposed to amend and enhance various features of their deposit insurance schemes. Key enhancements include raising the coverage limit and expanding the scope of coverage to replace the government blanket guarantee. In Hong Kong, the proposed coverage limit was raised substantially to HKD500 000 from HKD100 000 while Singapore proposes to raise theirs from SGD20 000 to SGD50 000. In addition, the Singapore Deposit Insurance Corporation will also expand their protection to include policyholders of the insurance industry. The Federal Deposit Insurance Corporation, meanwhile, will decide soon whether they will end a government guarantee for special deposit accounts in banks used by businesses. In Malaysia, we are looking into the features of an improved deposit insurance scheme that would meet public expectations, promote public confidence and maintain the stability of the financial system.

II. MDIC'S ROLE IN MANAGING THE TRANSITION

In the current context, an exit strategy is a strategic plan that guides the approach to unwinding the various extraordinary measures implemented to mitigate the effects of the financial crisis. There are three main areas which required orderly unwinding. They include the unwinding of monetary stimulus to anchor inflationary expectations, cutting back government fiscal support to banks and to the broader economy in a sustainable manner and third, transitioning from a government blanket guarantee to a limited deposit insurance system to minimize the risks associated with moral hazard.

The overarching objective in the unwinding process of these three areas is to maintain public confidence and financial system stability. I shall now outline Malaysia's plans to unwind the 'GDG'. And, since unwinding a blanket guarantee carries potential negative effects on depositor confidence, I believe the task to unwind a blanket guarantee is the trickiest of the three. As a deposit insurer, we are in frequent direct contact with depositors during a crisis. We, therefore, understand how fragile and irrational depositor confidence can be! Once confidence begins to erode, it can do so very rapidly. Many of the challenges that deposit insurers face while managing a transition arise from managing and meeting public expectations. This is the heart of the matter. If the general public has a concern with the exit plan, this may undermine their perception of the safety of their savings in the banking system. In turn, this may culminate into financial instability through bank runs. And internationally, mobile capital could head elsewhere.

In Malaysia, the implementation of the GDG in October 2008 was a pre-emptive measure to maintain financial system stability. Malaysian banks were well capitalized and the banking system was liquid. In Malaysia, we hear daily from depositors through our call centre operators and we go down to the ground to meet regularly with depositors through face-to-face meetings via our outreach programmes. We were, therefore, surprised when some depositors expressed concerns that the GDG was seen as a preliminary measure to address hidden banking system issues. This is an example of unexpected depositor perception that can arise anywhere even when a government deposit guarantee is put in place.

We were able to address depositor concerns and expectations early and effectively since they were limited to a very small group of depositors. From 2009, we have been monitoring the level of depositor confidence and their issues of concern arising from the implementation of the GDG. We maximized the direct contacts with depositors. Indeed, the face-to-face

meetings were most useful as they provided opportunities for us to understand the pulse of depositors, their concerns and expectations. They enabled us to identify, at an early stage, the strands of concerns amidst the chatter and the noise of depositor talk. In this regard, depositors indicated a preference for a higher level of deposit insurance coverage. This was confirmed by a survey conducted by MDIC to gauge the level of deposits maintained with our member banks. Based on this survey, the level of deposits held by banks had grown significantly since the establishment of MDIC in 2005. By 2009, only 60 per cent of depositors would be covered in full under the RM60 000 deposit insurance limit.

As the deposit insurer, the MDIC is responsible for developing and recommending the exit strategy plan to the government in consultation with the Central Bank of Malaysia. Depositor expectations and other issues are incorporated into the strategic transition plan which we believe will maintain depositor confidence in the stability of the financial system, even after the GDG exit.

Suffice it to say that we consider a well-planned exit strategy as the pillar of a smooth transition. Our exit strategy plan outlines the objectives of the strategy, the timetable, contingency plans, and policies and processes to execute the exit plan. And there is a substantial amount of planning required if one is to exit the GDG in a manner that would promote and enhance public confidence. I am not at liberty to discuss the details of the financial consumer protection package which we have developed. What I will highlight is MDIC's role in managing the transition. They are as follows:

- Designing the financial consumer protection package to be implemented after the expiry of the GDG. This would involve developing an improved deposit insurance scheme to take into account MDIC's current deposit insurance limit and scope of coverage. This includes a recommendation on changes to the *MDIC Act*, new regulations and new coverage limits, if necessary, taking into consideration depositor sentiments. In my view when exiting from a GDG, it is important to provide for a higher limit and scope of coverage to create a 'feel good' sense among depositors and be adequate enough to meet their needs for the next few years. To be credible, in deciding by how much the present deposit insurance programme could be increased, it would generally be necessary to cover between 85 per cent to 95 per cent of depositors in full. In Malaysia, we plan to achieve a coverage limit that would slightly exceed the public's expectations. Therefore, we plan to cover a minimum of 95 per cent of all depositors in full while ensuring between 35 per cent to 45 per cent of deposits, in terms of value. It would not work if the new

coverage is seen to be inferior to previous benefits, be it actual or perceived;

- Implementing a new Regulation to require banks to provide clearer product information to depositors. Conventional and Islamic banks would have to inform depositors on whether a deposit product is insured or not insured prior to a sale. This imposes new responsibilities on MDIC which will have to determine and inform the banks of the insurability status of all new deposit products prior to these products being offered for sale to bank customers. The objective is to provide depositors with knowledge of what *is* and what *is not* insured prior to making investment decisions;
- Developing and executing a communications plan. This would enable clear communication with the general public to ensure that they are fully informed about the new arrangements well before exit. Focus groups would also be conducted to assess depositors' acceptance of the proposed package; and
- Recommending the timing of the announcement of the financial consumer protection package. This is important for us. To maximize benefits, we would prefer that the announcement be made against a backdrop of good news.

III. SOME GENERAL FEATURES FOR AN EFFECTIVE EXIT PLAN

Having gone through the experience of developing an exit strategy plan, I would like to share some general features for an effective plan. I am aware that the challenges may differ from one country to another. Hence, there are no simple answers and there is no 'one size fits all' way of going about a plan.

Close cooperation and support between all relevant safety net players in planning and executing the exit plan is vital. Even with an effective transition strategy on paper, it would still not be effective if the implementation is not well coordinated.

First, it is the responsibility of all safety net players to work together to develop a comprehensive exit plan. Second, as separate and independent organizations, the roles of each agency need to be clearly understood as all agencies must know who is to do *what* and *when* to avoid unproductive overlap! This would also minimize the likelihood of agencies acting at cross purposes, and sending out conflicting signals and messages, which would not only seriously undermine public confidence, but, in turn, affect the credibility of the safety net players.

Clear communication of an exit plan with the general public is critical. A potential concern is that the exit strategy could cause confusion among depositors. Drawing from our own experience that even a GDG can bring unintended perceptions, it is important to understand depositor concerns and expectations through regular communications. Hence, it is the responsibility of the deposit insurer to mitigate this risk by communicating clearly the policy intentions of the exit plan and to explain the purpose for the direction taken. In other words, the plan has to be clear and needs to be constantly communicated to the general public. That is why the communication plan and strategy is a very important component of the transition package. In fact, this would be the most active phase of the entire transition.

An exit plan that is communicated early and regularly can bolster its effectiveness in a number of ways. First, it would ensure that the public is fully informed about the exit and its related timelines as well as the new or improved deposit insurance arrangements well before the exit. Second, if communicated early and effectively, depositors would be better prepared and would have enough time to adjust to the new circumstance ahead of the exit. This would ensure public acceptance of the new or improved deposit insurance system, which would, in turn, reduce market uncertainties. And the heavy costs of catching the public by surprise could be avoided.

What communications approach is best? The communications approach that we proposed to adopt is to position the financial consumer protection package as a ‘good news’ story by informing depositors of the benefits of the new features of a financial consumer protection package being implemented. In other words, we want to draw the attention of the public to the financial consumer package. It will also be positioned as giving depositors a sense of comfort and well being. This means informing the public that the package is in their best interests as it provides explicit benefits. For example, pointing out that blanket guarantees do not always benefit depositors in every aspect. They have attractions but also problems. Blanket guarantees do not specify a statutory timeline for depositors to be reimbursed, unlike statutory explicit limited deposit insurance systems. Also, an implicit government blanket guarantee would mean that any cost incurred does not fall on those who received the benefits. Hence, it is ‘heads, the banks win, tails, the taxpayers lose’. Reverting to an effective deposit insurance system would eliminate that distortion.

- i. One of the challenges we face is whether we should test public response to the proposed transition package. We are inclined to do this since the implications of missing the mark would be too costly.

To ‘test the water’, we proposed to put up ‘trial balloons’ to gauge public reaction to different coverage proposals. This could be a simple announcement to the press on the key features of the new depositor protection package, such as a proposed limit. At this time, we also plan to monitor closely the sentiments of the depositing public for any signs of public concern. Depositors may react by transferring their deposits to banks that are perceived to be ‘too-big-to-fail’ or take flight to quality. Depending on depositor reaction, deposit insurers may, if necessary, opt to scale up the transition package to converge with depositor expectations.

- ii. Malaysia is an open economy with strong economic links to neighbouring jurisdictions which have also implemented similar government guarantees that are also scheduled to expire on 31 December 2010. There are, therefore, strong arguments for international coordination. Such arguments are magnified in the light of the recent crisis. Having seen the *ad hoc* actions taken to maintain public confidence during the crisis, I am mindful of the past mistakes of implementing measures without proper consideration of their long-term implications. When announcing the blanket government deposit guarantee, many jurisdictions did not put much thought into cross-border issues and repercussions, mitigating moral hazard and developing orderly plans on how to exit from such measures when their economies stabilized. This is a risky strategy. Such haphazard policy decisions must be avoided when developing and executing an exit plan.

This is, indeed, one area which I feel the importance is clearly underappreciated. Uncoordinated exits and inconsistent exit frameworks can lead to potential disruptions and erode public confidence. Countries with high cross-border banking and strong retail deposit flows are particularly vulnerable.

We look towards working with our neighbours in the region in three areas. There will be challenges, since not all deposit insurers have autonomy of operations. Nonetheless, the following are areas for cooperation:

- Sharing of information and experiences. There are definitely clear gains from the exchange of information as countries can then learn from one another. The information shared could help other jurisdictions in formulating their own exit policy decisions. Countries could share with each other relevant information such as the broad principles underpinning exit decisions and information on cross-border fund movements. More importantly, they could give prior notification on decisions and plans that are to be shortly implemented in other jurisdictions.

- Planning for synchronized exits for close financially linked countries to minimize competitive distortion, potential spillovers and arbitrage risks. One example is the tripartite agreement between Hong Kong, Singapore and Malaysia to exit at the same time. In an ideal scenario, all countries should exit at the same time. This would ensure a level playing field among financial institutions and minimize cross-border impact by avoiding harmful spill-over, competitive distortions and arbitrage opportunities.

However, this is easier said than done. The difficulty here is country-specific circumstances, which influenced the timing of the exit of a jurisdiction. Circumstances such as the strength and robustness of a country's financial system and the state of the social and economic environment might vary from country to country. This is a key constraint to a common exit. But I think there is strength in numbers. And there are potential gains for all. By exiting together, there might be less to lose but more to gain!

- Implementing a consistent deposit coverage framework for closely linked countries. This could include roughly similar limits and levels of coverage, simultaneous announcements and implementation of policy changes.
- iii. Another challenge is to have in place a contingent plan should economic conditions not be conducive for removing the blanket guarantee. This is necessary for two reasons. First, a back-up liquidity line may be needed from the central bank to ensure adequate liquidity in the banking system when there might be capital outflows following an exit from the GDG. Second, there are situations where delaying an exit may prove less destructive to the economy. In such an extreme case, policymakers may have no choice but to extend the blanket guarantee. If the transition strategy is well planned and well executed, I doubt that the contingent measures would ever be called upon. However, it is important to know in advance, from a strategic planning perspective, that such contingency plans are in place to deal with key risks, if necessary.
 - iv. We also plan to determine a sunset date for the public announcement of the new package. It is crucial to determine upfront the sunset date as it is the date that will kick-start the transition plan. Since the exit is timed for 31 December 2010, as in Malaysia's case, we will be looking at a sunset date of June 2010 as it requires some six months to prepare the action plans.

IV. CONCLUSION

Ladies and gentlemen, the above are the main features of Malaysia's approach to a smooth exit strategy to its GDG. The plan will be tested over the next few months. While certain areas will continue to be refined, we are hopeful that the exit strategy plan is robust to ensure a smooth exit. This has been a complex task for us since Malaysian depositors have only known MDIC for five years. While we have built our reputation and credibility with depositors over the last five years, the test is when the lapse of the GDG is a non-event in the eyes of depositors.

In the eyes of the public, MDIC is the organization which provides the GDG. This was a strategic decision to maintain MDIC's credibility and image. As we well know, the implementation of a blanket guarantee normally causes the deposit insurer to sit out on the sideline during the period of the blanket guarantee. In Malaysia's case, the government's blanket guarantee is designed to cover deposits over and above the statutory limit of RM60 000 provided by MDIC. As such, MDIC functions alongside the government blanket guarantee. We continue to maintain our deposit insurance relationship with depositors and through our on-going depositor awareness programmes during the blanket guarantee. Indeed, we have put in many hours building our relationship with depositors. With so much at stake, there is no room for error.

Thank you.

NOTE

1. Many thanks to Wai Keen, Lai and Kevin Chew for their research and contribution to these remarks.